Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1977

No. 77-1016

UNITED CALIFORNIA BANK and LILLIAN DISNEY TRUYENS, Co-Executors of the Estate of WALTER E. DISNEY,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

GIBSON, DUNN & CRUTCHER,
JOHN J. SWENSON,
RONALD E. GOTHER,
MARC R. ISAACSON,
515 South Flower Street,
Los Angeles, Calif. 90071,
(213) 488-7000,
Attorneys for Petitioners.

Parker & Son, Inc., Law Printers, Los Angeles. Phone 774-6622

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Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Jurisdiction.

The judgment of the United States Court of Appeals for the Ninth Circuit was entered on October 19, 1977, reversing the District Court's judgment dated December 9, 1974, in favor of the petitioners. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Question Presented.

Whether the Court of Appeals erred in requiring the petitioners to include, in the amount of long-term capital gains subject to the alternative tax under § 1201(b) of the Internal Revenue Code of 1954, the portion of such gains which was owned by a tax-

exempt charitable organization and held by the petitioners in their capacity as co-executors of a decedent's estate.

Statement of the Case.

Petitioners are the co-executors of the estate of Walter E. Disney, who died on December 16, 1966, a resident of the County of Los Angeles, California. By the terms of his will, Mr. Disney left 45% of the residue of his estate to the Disney Foundation, as trustee for both the Disney Foundation and the California Institute of the Arts, both of which entities are charitable organizations, exempt from tax under Internal Revenue Code § 501(c)(3) [26 U.S.C. § 501(c)(3)].[1]

During each of the years 1967 and 1968, the petitioners, as co-executors of Mr. Disney's estate, sold certain securities which were included in the residue of Mr. Disney's estate and realized long-term capital gains on said sale. Pursuant to the terms of Mr. Disney's will, 45% of said net long-term capital gains was permanently set aside to the Disney Foundation, as charitable trustee.

In their Fiduciary Income Tax Returns for the years 1967 and 1968, the petitioners computed the estate's income tax by applying the alternative tax on capital gains provided by Internal Revenue Code § 1201(b).[2] At all times relevant to this case, § 1201(b) prescribed, in effect, a maximum tax of 25% on long-term capital gains, this tax being characterized as an "alternative tax" in the sense that it is utilized as an alternative

[1]See Appendix. All statutory provisions set forth therein appear in the versions which were in effect during the taxable years in question.

[2]See Appendix.

to the "normal" tax provided by § 1202.[3] Since § 1202 permits the taxpayer to deduct from gross income an amount equal to 50% of net long-term capital gains, application of § 1202 results in a tax on long-term capital gains at a rate equal to one-half of the taxpayer's marginal rate. Thus, when the taxpayer's marginal rate exceeds 50%, the effective rate on long-term capital gains resulting under § 1202 will exceed 25% and the taxpayer will, as an alternative, utilize the 25% rate provided by § 1201(b).

At all times relevant to this case, § 501(c)(3) of the Internal Revenue Code exempted from income tax charitable organizations such as the Disney Foundation, and § 642(c)[4] allowed to estates and trusts an unlimited deduction for amounts paid to, or set aside to, such charitable organizations. Under the relevant local law, Calif. Probate Code § 300,[5] the Disney Foundation, as designated beneficiary under Mr. Disney's will, held title to 45% of the residue of Mr. Disney's estate from the time of his death, subject to the possession of the petitioners and the control of the probate court for purposes of estate administration.

Based upon the foregoing statutory provisions, and the policy underlying them, petitioners viewed themselves, with respect to 45% of the estate's residue, merely as conduits for the Disney Foundation, holding possession to property of which a tax-exempt charitable organization was the owner and receiving as such conduits any capital gains which resulted from sales out

[3]See Appendix.

[4]See Appendix.

[5]See Appendix.

of that charitable organization's 45% interest. Accordingly, in computing the alternative tax under § 1201(b) in this case, the petitioners did not include the Disney Foundation's 45% interest in the capital gains in the amount of capital gains subject to the alternative tax. Thus, no tax was paid on the said 45% and the remaining 55% of the capital gains received the benefit of the alternative tax, the same result which would have occurred had the petitioners distributed to the Disney Foundation 45% of the securities which were sold and had said charitable organization itself sold said 45% of the securities.

The respondent, however, disallowed the petitioners' exclusion of the said 45% from the amount to which the alternative tax was applicable, the respondent taking the position that, in the application of the alternative tax in the case of an estate or trust, said tax must be imposed not only on that portion of the gain passing to taxable beneficiaries but also on that portion of the gain which is owned by a tax-exempt charitable beneficiary. As a consequence of respondent's disallowance, the alternative tax was unavailable to the Disney estate and the petitioners were required to pay additional amounts of tax and interest.[6] The petitioners

[6]The additional tax resulting from the application of § 1202 in this case may be demonstrated by a simplified example. Assuming ordinary taxable income of $20,000, capital gains of $500,000, and a governing instrument giving 50% of the estate to charity, the estate would compute the tax under § 1201(b) by computing the "partial" tax on the ordinary income (computed as follows: partial tax, assuming 30% effective rate = $20,000 x 30% =$6,000) and then adding to the "partial" tax the 25% capital gains tax, computed on that 50% portion of the capital gains which was not set aside to charity (capital gains tax = $500,000 x 50% x 25% = $62,500). Thus, the total tax as computed by the estate under § 1201(b) would be $68,500 ($6,000 + $62,500 = $68,500).

Assuming a 60% effective rate under § 1202, the tax under that section would be computed by subtracting from gross income both the 50% capital gains deduction under § 1202 and the charitable set aside deduction under § 642(c), and by then applying the 60% rate to the balance, as follows:

§ 1202 tax = 60% x ($20,000 + $500,000 − $250,000 — $125,000)
§ 1202 tax = 60% x $145,000
§ 1202 tax = $87,000

Since the tax computed under § 1202 would thus exceed the tax computed by the estate under § 1201(b), the estate would utilize § 1201(b) and pay the tax resulting under that section.

Under respondent's theory, however, the capital gains tax under § 1201(b) would be computed on 100% of the capital gains, including that portion owned by and set aside to charity. Thus, respondent would compute the § 1201(b) capital gains tax as follows: $500,000 x 100% x 25% = $125,000. The total tax under respondent's computations would be $127,000 ($2,000 + $125,000 = $127,000). Since this amount exceeds the tax computed under § 1202, the respondent's position would compel the estate to apply § 1202, even though the tax resulting under § 1202 exceeds the tax computed under the estate's application of § 1201(b).

Petitioners herein recognize that the application of § 1202 does, in effect, exempt from tax the amount set aside to charity, as the tax is computed *under that section*. However, this fact merely highlights the anomalous result of respondent's position, which is to deny tax exemption to such amounts when the tax is computed under § 1201(b). Congress can hardly have intended that estates and trusts having charitable beneficiaries be penalized in their utilization of § 1201(b), by comparison to the tax treatment accorded them under § 1202.

paid said additional amounts of tax and interest and filed timely refund claims therefor. Following the respondent's disallowance of said refund claims, the petitioners filed the complaint herein, and, after a trial upon stipulated facts, the District Court rendered judgment in favor of the petitioners. The respondent thereupon filed its appeal, and, following the hearing of said appeal, the Ninth Circuit Court of Appeals reversed the judgment of the District Court and entered judgment for the respondent.

REASONS FOR GRANTING THE WRIT.

The decision of the Ninth Circuit Court of Appeals in this case is in direct conflict with the decision of the Second Circuit Court of Appeals in *Statler Trust v. C.I.R.* (2nd Cir. 1966), 361 F.2d 128, reversing *Ellsworth M. Statler Trust* (1964), 43 Tax Ct. 208. In *Statler,* the Second Circuit held that trustees, who were required by their governing trust instrument to distribute to charities at least 15% of the trust's net income each year, were entitled to exclude the 15% of the trust's net long-term capital gains so distributed from the amount of net long-term capital gains to which the alternative tax provided by § 1201 (b) was applicable. The Second Circuit reasoned "that an estate or trust is in general treated as a conduit through which income passes to the beneficiary". H.R. Rep. No. 1337, 83rd Cong., 2d Sess., p. 61 (3 U.S. Code Cong. & Adm. News (1954), 4017, 4087), partially quoted in *Statler v. C.I.R.* (2nd Cir. 1966), 361 F.2d 128, 131.

The Second Circuit in the *Statler* case recognized that the essence of the conduit principle is to treat the income of the fiduciary "not as the trust's income but as the beneficiary's" and that under that principle "the beneficiary's share of the income is considered his property from the moment of its receipt by the estate." *Freuler v. Helvering* (1934), 291 U.S. 35, 41-42, 54 S.Ct. 308, 78 L.Ed. 634, 640, quoted in *Statler* at 361 F.2d 128, 131. Since a trust which receives income for a charitable beneficiary is merely a "conduit" for that charity, the Second Circuit held that the tax treatment accorded to such income should be the same as though that income had been received

by the charity itself and, in the specific context of § 1201(b), that the amount of capital gains to which the alternative tax is applicable does not include such capital gains as an estate or trust is required to pay or set aside for charitable purposes.

Given the similarity between the facts of the *Statler* case and the facts of this case, it is clear that had this case arisen within the jurisdiction of the Second Circuit, that court would have decided this case in favor of the petitioners. Indeed, to the extent that the facts of this case differ from those of the *Statler* case, this case presents an even stronger situation for the taxpayer. In *Statler,* the governing trust instrument gave the trustees discretion to distribute each year not less than 15% nor more than 30% of the trust's net income for the year among such charitable organizations, and in such amounts, as the trustees determined. Consequently, it could not be said in the *Statler* case that any of the charitable beneficiaries of the trust had a vested right to any amount or portion of the trust's income. In this case, however, the *Disney Foundation,* under the terms of Mr. Disney's will and the relevant California law, held *title* to 45% of the residue of Mr. Disney's estate from the time of Mr. Disney's death, and the petitioners, as co-executors of Mr. Disney's estate, merely had *possession* of the estate residue for purposes of administration. Accordingly, the petitioners in this case were, in a more literal sense than were the trustees in *Statler,* mere conduits for a charitable beneficiary.[7]

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[7]This circumstance further distinguishes the petitioners' situation from that in *Weil v. Commissioner of Internal Revenue* (6th Cir. 1956), 229 F.2d 593, in which an individual taxpayer was

(This footnote is continued on next page)

Notwithstanding the Second Circuit's decision in the *Statler* case, and the fact that the instant case presents an even stronger occasion for the application of the reasoning and decision of the Second Circuit, the Ninth Circuit expressly rejected the Second Circuit's holding in *Statler* (opinion below, at 563 F.2d 400, 402, 406), refusing to apply the conduit principle in the case of charitable beneficiaries of an estate or trust and holding that, even though proceeds received by an estate are derived from the sale of property which was owned by a charitable beneficiary of the estate, such proceeds are not entitled to the same income tax treatment which they would be accorded had the proceeds been received directly by the charity itself. By so holding, the Ninth Circuit sustained the respondent's position that in the application of the alternative tax such tax must be imposed even on that portion of capital gains which is owned by, and set aside to, a tax-exempt charitable beneficiary; and, by expressly rejecting the Second Circuit's decision in *Statler*, the Ninth Circuit's decision has created a square conflict between the Circuits.

The Ninth Circuit's disagreement in this case with the reasoning and conclusion of the Second Circuit in *Statler* was based upon its erroneous conclusion that the conduit principle does not pertain to amounts of income passing to charities and upon its needlessly formalistic reading of Internal Revenue Code § 1201

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not permitted to deduct his charitable contributions (in excess of his ordinary income) from the amount of his capital gains in computing the alternative tax thereon. As the Second Circuit noted in *Statler*, the voluntary nature of the taxpayer's charitable contributions in *Weil* afforded the court in that case no occasion to consider the applicability and effect of the conduit principle. 361 F.2d 128, 131.

(b). While both the respondent and the Court below have recognized the applicability of the conduit principle in the case of taxable beneficiaries of estates and trusts, the Ninth Circuit distinguished the situation of nontaxable charitable beneficiaries on the purported ground that conduit treatment for such beneficiaries does not "emerge boldly from the Code's language." 563 F.2d 400, 404. In so concluding, the Circuit Court not only misconstrued the pertinent provisions of the Internal Revenue Code, but it disregarded the historical foundations of the conduit principle, and the strong Congressional policy underlying that principle, as it applies to charitable beneficiaries.

The applicability of the conduit principle in the context of charitable beneficiaries of estates and trusts has been judicially recognized since almost the earliest enactments of the modern federal income tax law. As early as the Revenue Acts of 1916 and 1918, it was recognized that "the purpose of the statute is to exempt from taxation all income essentially belonging to religious, charitable, scientific or educational corporations," *Slocum v. Bowers* (S.D. N.Y. 1926), 15 F.2d 400, 405, aff'd sub nom. *Bowers v. Slocum* (2nd Cir. 1927), 20 F.2d 350, and that "the expressed intent of the Congress . . . was to tax the income received by the estate which would pass to any person subject to taxation, but relieve from taxation the income set aside by the terms of the will for corporations of [charitable] character . . .". *Bowers v. Slocum* (2nd Cir. 1927), 20 F.2d 350, 352.

The congressional intention to exempt from taxation "all income essentially belonging to" charitable organi-

zations requires that such amounts not be subjected to tax simply because of an executor's failure to distribute such amounts to the charitable organization. *Slocum v. Bowers, supra,* 15 F.2d 400, 405. Yet such additional tax is the inevitable consequence of the Circuit Court's decision in this case. If the petitioners, instead of selling the residuary securities allocable to the Disney Foundation, had distributed those securities to the Foundation, there can be no question but that any gains realized by the Disney Foundation on its own subsequent sale of those securities would have been wholly exempt from tax, while at the same time the gains realized on the remaining 55 percent of the residuary securities would have been eligible for the alternative tax provided by Section 1201(b). The Ninth Circuit's decision in this case causes the amount of the tax to depend squarely upon whether the representative of the estate has exercised his discretion to seek a partial distribution of the estate, a result clearly at variance with long recognized and clearly expressed Congressional intent.

In seeking statutory support for its rejection of the conduit principle in the case of charitable beneficiaries, the Ninth Circuit in this case reasoned that if the conduit principle were applicable to such beneficiaries, Congress would have provided that amounts distributed to or set aside for charities are to be "excluded" from the gross income of the estate or trust rather than simply "deducted" as § 642(c) provides. Such reasoning overlooks the fact that the income of an estate or trust which is distributed to taxable beneficiaries (to whom, as the Ninth Circuit recognizes, the conduit principle does apply) is also not excluded from the gross income of the estate or trust but is

simply deducted, in that case under § 661. The Ninth Circuit in this case seems to have concluded that since amounts distributed to or set aside to charitable beneficiaries are not given conduit treatment identical to that given to taxable beneficiaries, such amounts are not given conduit treatment at all. Such analysis, apparently premised on the Ninth Circuit's assumption that the conduit principle can be expressed through only one statutory scheme, ignores the fact that the statutory provisions governing the taxation of estates and trusts provide very clearly, albeit separately, for the conduit treatment of amounts passing to charitable beneficiaries, creating, in effect, one system of conduit treatment for taxable beneficiaries and a separate system of conduit treatment for charitable beneficiaries.

The system of conduit treatment for charitable beneficiaries, far from being absent in the provisions of the Internal Revenue Code, is in fact a far stronger manifestation of the conduit principle than that system of conduit treatment which is provided for taxable beneficiaries. Sections 661 and 662 provide conduit treatment for taxable beneficiaries by allowing as a deduction to the estate or trust, and requiring to be taken into income by the recipient, only such amounts as are "properly paid or credited or required to be distributed" during the taxable year. Other amounts, properly retained by the estate or trust during the taxable year, are not given conduit treatment but are instead generally taxed to the estate or trust as that entity's taxable income. On the other hand, § 642(c), which implements the conduit principle in the case of charitable beneficiaries, gives the estate or trust an unlimited deduction not only for amounts which are paid for charitable purposes during the taxable

year, but also for amounts which during the taxable year are "permanently set aside" for such purposes. Thus, while the conduit principle as exemplified by § 661 and § 662 operates only at the time of an actual or required distribution from an estate or trust, the conduit principle as manifested in § 642(c) operates from the moment of the estate or trust's receipt of the income item in question where, as in this case, such item is required to be set aside for charitable purposes.

Compounding its rejection in this case of the conduit principle's applicability to charitable beneficiaries, the Ninth Circuit has elected instead to "interpret section 1201(b) . . . precisely as it is written," 563 F.2d 400, 405. The Court below has observed that the language of § 1201(b) does not provide for any deductions from the amount of net long-term capital gains to which the alternative tax is applied. *Id.* However, a construction of § 1201(b) such as to deny the deduction which petitioners seek in this case and which the Second Circuit recognized and allowed in the *Statler* case is needlessly formalistic and harsh. Such construction not only disregards the long established and clearly expressed Congressional policy that conduit treatment is to be accorded amounts passing to charitable beneficiaries of estates and trusts; it also ignores the fact that the supposedly "precise" language of § 1201(b) is flexible enough to permit, in appropriate situations, a deduction from the amount of capital gains to which the alternative tax is applied. The cases of *Meissner v. United States* (Ct. Cl. 1966), 364 F.2d 409; *Read v. United States* (5th Cir. 1963), 320 F.2d 550; and *Estate of Harry B. Sidles* (1976), 65 Tax Ct. 873, demonstrate unequivocally that the language of § 1201

(b) permits a deduction, from the amount of capital gains to which the alternative tax is applied, when the effect of permitting such deduction is to further Congressional intent. In fact, the position of the Internal Revenue Service in the *Sidles* case reflects its acquiescence in this construction. The fact that these cases were concerned with a provision of the Internal Revenue Code[8] not related to those provisions pertaining to the taxation of estates and trusts does not, contrary to the Ninth Circuit's conclusion herein, make those cases "inapposite to the issue before us". 563 F.2d 400, 405. As those cases demonstrate, deductions will be permitted under § 1201(b) where such deductions are in furtherance of Congressional policy. Few Congressional policies are more clearly evidenced in the Internal Revenue Code than the policy to exempt from taxation amounts passing to charitable organizations. It has long been recognized that the statutory provisions reflecting this policy "were begotten from motives of public policy, and are not to be narrowly construed". *Helvering v. Bliss* (1934), 293 U.S. 144, 151, 55 S.Ct. 17, 20, 79 L.Ed. 246, 251. By its unduly narrow construction of § 1201(b), the Court below has also given an unduly narrow construction to the policy of charitable exemption which underlies the Internal Revenue Code.

Conclusion.

Regardless of whether the taxable beneficiaries or the charitable beneficiaries of the estate were to bear the additional tax resulting from the Circuit Court's decision in this case, the inevitable consequence of

[8] § 691(c), pertaining to a deduction which is based on the estate tax imposed on income in respect of decedents.

such tax would be to increase the cost of, and hence to discourage, individual contributions to charity. Such consequence, which would be in derogation of a strong Congressional tax policy favoring charities, can be easily avoided by a proper construction of the statutory provisions pertinent to this case, such as was adopted by the Second Circuit Court of Appeals in *Statler Trust v. C.I.R.* (2nd Cir. 1966), 361 F.2d 128. The Ninth Circuit Court of Appeals, in its decision herein, expressly rejected the reasoning and decision of the Second Circuit in *Statler,* adopting instead an erroneous and undesirable construction of those provisions and creating a clear conflict among the Circuits on an important question of federal law.

For all of the reasons stated herein, the petitioners respectfully request that this Court grant their petition for a writ of certiorari.

GIBSON, DUNN & CRUTCHER,
JOHN J. SWENSON,
RONALD E. GOTHER,
MARC R. ISAACSON,
Attorneys for Petitioners.

APPENDIX.

26 U.S.C. § 501.

(a) *Exemption from taxation.*—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503, or 504.

* * *

(c) *List of exempt organizations.*—The following organizations are referred to in subsection (a):

* * *

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office. (All statutory provisions set forth herein appear in the respective versions of such provisions which were in effect during the taxable years in question.)

26 U.S.C. § 1201.

* * *

(b) *Other taxpayers.*—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is

less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

26 U.S.C. § 1202.

In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

26 U.S.C. § 642.

* * *

(c) *Deduction for amounts paid or permanently set aside for a charitable purpose.*—In the case of an estate or trust (other than a trust meeting the specifications of subpart B) there shall be allowed as a deduction in computing its taxable income (in lieu of the deductions allowed by section 170(a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid or permanently set aside for a purpose specified in section 170(c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit. For this purpose, to the extent that such amount consists of gain from the sale or exchange of capital assets held for more than 6 months, proper adjustment of the deduction otherwise allowable under this subsection shall be made for any deduction allowable to the estate or trust under section 1202 (relating to deduction for excess of capital gains over capital losses). In the case of a trust, the deduction allowed by this subsection shall be subject to section 681 (relating to unrelated business income and prohibited transactions).

California Probate Code, § 300.

§300. *Estates All Subject to Court Administration—Exceptions*

When a person dies, the title to his property, real and personal, passes to the person to whom it is devised or bequeathed by his last will, or, in the absence of such disposition, to the persons who succeed to his estate as provided in Division II of this code; but all of his property shall be subject to the possession of the executor or administrator and to the control of the superior court for the purposes of administration, sale or other disposition under the provisions of Division III of this code, and shall be chargeable with the expenses of administering his estate, and the payment of his debts and the allowance to the family, except as otherwise provided in this code.

Opinion.

[563 F.2d 400]

UNITED CALIFORNIA BANK and Lillian Disney Truyens, Co-Executors of the Estates of Walter E. Disney, Plaintiffs-Appellees, v. UNITED STATES of America, Defendant-Appellant

No. 75-1616.

United States Court of Appeals, Ninth Circuit.

Oct. 19, 1977.

A decedent's estate instituted a suit for refund of certain taxes. The United States District Court for the Central District of California, Irving Hill, J., held in favor of the taxpayer, and the United States appealed. The Court of Appeals, Sneed, Circuit Judge, held that that portion of the estate's net long-term capital gain which was required to be set aside permanently for a charitable organization could not be deducted from the net long-term capital gain in calculating the alternative tax on capital gains when to do so was advantageous to the taxpayer.

Reversed.

[563 F.2d 401]

Mason C. Lewis, Asst. U. S. Atty., Los Angeles, Cal., Dennis M. Donohue, argued, Appellate Section, Tax Division, Washington, D. C., for defendant-appellant.

Marc R. Isaacson, argued, Los Angeles, Cal., for plaintiffs-appellees.

Appeal from the United States District Court for the Central District of California.

Before WALLACE, SNEED and KENNEDY, Circuit Judges.

SNEED, Circuit Judge:

The estate of Walter E. Disney (taxpayer) instituted a suit in district court for the refund of certain taxes assessed against it for the years 1967 and 1968. The district court held in favor of the taxpayer, and the United States appeals therefrom. We reverse.

I.
FACTS.

The parties stipulated to the following facts. Disney, by his will, left 45% of the residue of his estate to certain charitable organizations. During 1967 and 1968, appellees, United California Bank and Lillian Disney Truyens, co-executors of the estate, sold certain securities included in the residue of the estate, on which sales net long-term capital gains of $500,622.38 and $1,058,018.43 were realized in 1967 and 1968 respectively. In 1967, a net short-term capital gain of $16,944.16 also was realized. Pursuant to the terms of the will, appellees set aside 45% of these net long-term capital gains to the charitable organizations.

Appellees computed the taxpayer's income tax for the years 1967 and 1968 under the alternative tax described in I.R.C. § 1201(b).[1] In computing the

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[1]The version of Section 1201(b) in effect at that time provides:

> Other taxpayers.—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—
>
> (1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at

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tax, appellees deducted the 45% of the net long-term capital gain which had been permanently set aside for charitable purposes from the total net long-term capital gain, which is taxed at a flat rate of 25%.

Appellant United States, through the District Director of Internal Revenue, Los Angeles, California, disallowed this deduction. Without the deduction, the alternative tax was higher than the normal tax, so appellant computed the taxpayer's tax under the normal method and assessed deficiencies in the amounts of $4,998.93 for 1967 and $27,445.05 for 1968, plus interest of $1,099.76 and $4,386.41 for the respective years. Appellees paid these deficiencies and filed their complaint for a refund.

II.
THE CONTROVERSY.

While there are several ways in which the issue before us can be framed our formulation is whether that portion of the net long-term capital gain which is required to be set aside permanently for a charitable organization can be deducted from the net long-term capital gain in calculating the alternative tax under section 1201(b) when to do so is advantageous to the taxpayer. [563 F.2d 402] The district court, relying on the Second Circuit decision in *Statler Trust v. Commissioner of Internal Revenue*, 361 F.2d 128 (2d Cir. 1966), held in the affirmative. The Government, although recognizing that *Statler Trust* is on point, contends that *Statler Trust* was wrongly decided. We agree with the Government.

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the rate and in the manner as if this subsection had not been enacted, and
(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

The conflict between the Government and the taxpayer can be understood better if we set forth calculations derived from a hypothetical situation which reflect the competing views. Assume an estate in which in the taxable year 1967 one-half of the net long-term capital gains by the terms of the governing instrument is permanently set aside for charity. Assume further that in 1967 the estate realized and recognized $50,000 consisting of net long-term capital gains. Both the taxpayer estate and the Government agree that the taxable income of this hypothetical trust would amount to $175,000 calculated in the following manner:

Gross Income		$550,000
Less: Sec. 1202 deduction[2]	$250,000	
Sec. 642(c) deduction[3]	$125,000	
Total Deductions	$375,000	
Estate Taxable Income		$175,000

Assuming an effective rate of 60% the normal tax would amount to $105,000.

In computing the alternative tax the Government proceeds as follows:

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[2]I.R.C. § 1202 authorizes a deduction by a taxpayer other than a corporation of 50 percent of the excess net long-term capital gain over net short-term capital loss in computing taxable income.

[3]I.R.C. § 642(c). The operation of this section requires a bit of explaining. It authorizes a deduction by an estate or trust for "any amount of gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside" for charity. This suggests the deduction should be $250,000; however, this would permit a charitable deduction *and* a section 1202 deduction which would eliminate the entire amount of net long-term capital gain from taxable income although only one-half of it was permanently set aside for charity. This result is foreclosed by the provision in section 642(c) which requires that "proper adjustment of the deduction otherwise allowable . . . shall be made for any deduction allowable to the estate or trust under section 1202 . . ." Treas.Reg. § 1.642(c)-3 (1960). *See* M. C. Ferguson, J. Freeland, & R. Stephens,

(This footnote is continued on next page)

Estate Taxable Income	$175,000
Less: 50% of excess net long-term capital gain over net short-term capital loss.[4]	$250,000
Partial Taxable Income	—0—
Partial Tax	—0—
Tax on Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss (25% of $500,000)	$125,000

Inasmuch as the alternative tax so computed is greater than the normal tax of $105,000, the latter is the proper tax as the Government sees it.

[563 F.2d 403]

The taxpayer, troubled by the "wastage" of the excess ($75,000) of the $250,000 deduction over the estate's taxable income of $175,000, computes the alternative tax in a manner that eliminates the "wastage." Its method is as follows:

Estate Taxable Income	$175,000
Less: 50% of that portion of the excess of net long-term capital gain over net short-term capital loss *not permanently set aside for charity*. ($250,000)	$125,000
Partial Taxable Income	$ 50,000
Partial Tax (assume 60% effective rate)	$ 30,000
Tax on Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss *Not Permanently Set Aside For Charity*. (25% of $250,000)	$ 62,500
Total Alternative Tax	$ 92,500

By eliminating the "wastage" the alternative tax is less than the normal tax and thus is the amount owed by the taxpayer estate. The actual figures involved

Federal Income Taxation of Estates and Beneficiaries 372-73 (1970). That portion of the gain set aside for charity ($250,000) is reduced by that portion of it ($125,000 or one-half of the total) already deducted by reason of section 1202. The balance, $125,000, constitutes the section 642(c) deduction.

[4]I.R.C. § 1201(b)(1).

in this case are different, although within the same range of magnitude of those above.[5]

III.
THE RELEVANT STRUCTURE OF THE CODE.

The Code could be drafted in a manner that would conform to the taxpayer's [563 F.2d 404] wishes. Unfortunately, it is not so written. To conform to the taxpayer's understanding the applicable provisions of the code should reflect a consistent pattern of treating sums distributed to, or permanently set aside for, char-

[5]For example, using the rounded-off figures for 1967, the competing methods show the following calculations.

Normal Tax		
Gross Income		$595,000
Less: § 1202 deduction	$250,000	
§ 642(c) deduction	$145,000	
Other deductions	$ 54,000	
	$449,000	
Estate Taxable Income		$146,000
Tax (regular rates)		$ 88,000
Alternative Tax		
(1) Taxpayer's Method.		
Estate Taxable Income		$146,000
Less: 50% of that portion of the excess of net long-term capital gain over net short-term capital loss not permanently set aside for charity		$137,500
Partial Taxable Income		$ 8,500
Tax (normal rates)		$ 1,800
Tax on Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss Not Permanently Set Aside For Charity (25% of $275,000)		$ 69,000
Total Alternative Tax		$ 70,800
(2) Government's Method.		
Estate Taxable Income		$146,000
Less: 50% of excess of net long-term capital gain over net short-term capital loss		$250,000
Partial Taxable Income		—0—
Tax on Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss (25% of $500,000)		$125,000
Total Alternative Tax		$125,000

ity as amounts substantially insulated from other transactions affecting the taxable status of the estate or trust or its beneficiaries occurring during the relevant taxable period. In short, "conduit" treatment of such sums should emerge boldly from the Code's language. It does not.

To begin with, "conduit" treatment would suggest that amounts distributed or set aside for charity would be *excluded* from the distributable net income of the estate or trust as described in section 643 and, in determining the amount includible in the gross income of an estate or trust beneficiary, section 662 would allocate only an amount reduced by such distributions or set asides. Correspondingly, no portion of such distribution or set asides directly would be allocable to items distributable to non-charitable beneficiaries. Finally, there would be no *deduction* for amounts paid or permanently set aside for charity in computing the taxable income of the estate or trust; such amounts would simply be *excluded* from the gross income of the estate or trust.

The present Code proceeds differently. Amounts distributed or set aside to charity are not excluded from the computation of distributable net income pursuant to section 643. Even when such amounts consist of capital gains they remain in distributable net income. I.R.C. § 643(a)(3). Amounts includible in the income of non-charitable estate or trust beneficiaries are limited to distributable net income which is arrived at after allowance of an unlimited *deduction* for charitable distributions or set asides. I.R.C. § 662(a), § 642(c). This deduction is "allocated among the items of distributable net income" (I.R.C. § 662(b) 3rd sentence) which items, in the hands of non-charitable distributees,

retain the same character they had in the hands of the estate or trust. I.R.C. § 662(b); Treas.Reg. § 1.662(b)-2 (1960).

More directly to the point of this case, a "conduit" approach with respect to charitable distributions and set asides would involve a different method of calculating the normal tax than that which both the taxpayer and government agree is proper. To illustrate, return to the foregoing example. A "conduit" approach would result in the following normal tax computation:

Gross Income as Adjusted (Receipts of $550,000 Reduced by Amount Set Aside to Charity $250,000)	$300,000
Less: Section 1202 deduction (50% of that portion of the excess of net long-term capital gain over net short-term capital loss *not permanently set aside for charity.*)	$125,000
Estate Taxable Income	$175,000[6]

Assuming an effective rate of 60%, the normal tax is the same as under the proper computation method. The difference, however, is that it is clear that section 1202 and [563 F.2d 405] 642(c) do not countenance a "conduit" approach in calculating the normal tax. To the extent that further proof of the Code's rejection of this approach in the present context

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[6]Even if the set aside or distribution to charity remains in the gross income of the estate a computation method more in keeping with the taxpayer's would be as follows:

Gross Income		$550,000
Less: Amount Set Aside to Charity	$250,000	
Section 1202 Deduction	$125,000	
Total Deduction		$375,000
Estate Taxable Income		$175,000

Neither method of computing the normal tax is employed. The proper method is that set forth on p. 2391, *supra*.

is required, it is supplied by the second sentence of section 1202.[7] This sentence *permits* the exclusion of capital gains which under sections 652 and 662 are includible in the gross income of income beneficiaries of estates or trusts as gain derived from the sale or exchange of capital assets. No mention is made of excluding capital gains distributed to or set aside for charity. Consistent application of the conduit approach would require such a provision.

Confronted with these numerous inconsistencies between the taxpayer's conduit theory and the structural characteristics of the applicable portions of the Code we believe the proper course is to follow closely the Code's precise language. Being so guided we are less likely to disturb a carefully constructed balance among intricately designed sections which to us may be in part both unseen and unknown. Being so guided we interpret section 1201(b), which describes the method by which the alternative tax is to be computed, precisely as it is written.[8] The excess of the net long-term capital gain over the net short-term capital loss for the purpose of this section is required to be computed without reduction for any amount distributed to or set aside for charity. No such reduction is authorized any more than is a similar reduction under section 1202.

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[7]This sentence reads:

> In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

[8]Footnote 1, *supra*. *See Weil v. Commissioner of Internal Revenue*, 229 F.2d 593 (6th Cir. 1956).

IV.

THE RELEVANT AUTHORITIES.

Taxpayer, in addition to *Statler Trust*, relies heavily on cases which have permitted the deduction under section 691(c) for estate taxes properly allocable to income in respect of a decedent against long-term capital gains in computing the alternative tax. *Meissner v. United States*, 364 F.2d 409, 176 Ct.Cl. 684 (1966); *Read v. United States*, 320 F.2d 550 (5th Cir. 1963); *Sidles v. Commissioner of Internal Revenue*, 65 T.C. 873 (1976)[9] We express no opinion with respect to the correctness of these decisions. They are, in any event, inapposite to the issue before us.

It is true, of course, that these decisions adopt an approach that precludes the "wastage" of section 691(c) deductions in computing the alternative tax on capital gains and that the taxpayer here also seeks to avoid the "wastage" of a deduction in the same computation. The similarity between *Meissner*, *Read*, and *Sidles* and this case ends at that point, however. The charitable contribution deduction in Subchapter J dealing with the taxation of estates and trusts is carefully integrated into a very complex statutory pattern which, as already indicated, reflects a design inconsistent with the philosophy of the taxpayer's case. No such intricate fashioning appears with respect to the section 691(c) deduction. This section merely provides for a deduction for estate tax attributable to amounts regarded as income in respect of a decedent. It does not specify the manner in which the deduction

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[9]*See also Quick v. United States*, 503 F.2d 100 (10th Cir. 1974); *Goodwin v. United States*, 458 F.2d 108, 198 Ct.Cl. 88 (1972).

is to be utilized. Moreover, the avoidance of complete double taxation under the estate and income tax of items of income in respect of a decedent, which is the purpose of the section 691(c) deduction, provides a forceful reason for permitting the utilization of the deduction in computing the alternative tax.

[563 F.2d 406]

This reason is not applicable in the case before us. In holding as we do we do not subject capital gains to double taxation nor do we eliminate the effectiveness of the charitable contribution deduction for estates and trusts. While we do preclude the reduction of the flat tax on capital gains in calculating the alternative tax by refusing to permit the capital gains to be reduced by amounts paid or permanently set aside to charity, we do so in accordance with both the letter and the spirit of the applicable provisions of the Code. In this respect we cannot improve on the words of Judge Dooling who, in his dissent in *Statler Trust*, said, "The statute's effect is too plain to be supposed an inadvertent one, and it is far from being ungenerous. The alternatives are payment of the tax at ordinary rates on half the capital gain less the adjusted deduction for the part of it paid to charity or paying a tax on that same income amount equal to a quarter of the total capital gain." 361 F.2d at 133.[10] Essentially the same approach was taken in

[10]The present section 1201 imposes a heavier burden on the taxpayer than that described by Judge Dooling. I.R.C. § 1201(b). His point remains valid, however. The extent of the burden is prescribed by Congress; it should not be reduced by means not described by Congress. Its increasing complexity and specificity set it apart from the section 691(c) deduction.

Weil v. Commissioner of Internal Revenue, 229 F.2d 593 (6th Cir. 1956).

We, therefore, do not agree with the court in *Statler Trust* where, speaking through Judge Friendly, it characterized the Government's interpretation as both "unfair" and "unintended." *Id.* at 131. It is, in fact, neither. The court's reliance on section 643(a)(3)'s inclusion of charitable payments and set asides from capital gains in distributable net income to evidence a pervasive reliance on a conduit principle for such charitable provisions is misplaced. Section 643(a)(3), as already indicated, is part of a structure which in its entirety unmistakably rejects the conduit principle for charitable payments and set asides. Its specific purpose is to retain capital gains so paid or set aside in distributable net income so as to permit the allocation of the benefits of the deduction among items of distributable net income in accordance with section 662(b) and the regulations thereunder. Treas.Reg. § 1.643(a)-5(b) (1960); § 1.662(b)-2 (1960).

We are aware, of course, that any computation that reduces taxes on taxable beneficiaries because of charitable payments or set asides is directly advantageous to such beneficiaries and indirectly helpful to charities generally. While such a consideration in an exquisitely balanced situation might be controlling, the case before us is not such a situation. To permit such concerns to control here is contrary to the statute as written.

We therefore reverse and direct that the taxes for the years 1967 and 1968 be computed as the Government insists. The refunds sought are denied.

REVERSED.

Service of the within and receipt of a copy thereof is hereby admitted this ..... day of January, A.D. 1978.